No. 20281

United States
COURT OF APPEALS
for the Ninth Circuit

MURPHY LOGGING CO., successor by merger to Murphy Timber Co.; HARRY C. MURPHY and DOROTHY SHEA MURPHY; EDWARD J. MURPHY and VIRGINIA C. MURPHY; PETER C. MURPHY and DOROTHY Z. MURPHY,

Appellants,

v.

UNITED STATES OF AMERICA,

Appellee.

On Appeal from the Judgment of the United States District Court for the District of Oregon

BRIEF FOR THE APPELLANTS

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BRIEF FOR THE APPELLANTS

OPINION BELOW

The opinion of the District Court (R. 13) is reported at 239 F. Supp. 794.

JURISDICTION

This appeal involves federal income taxes for the calendar years 1959 and 1960 in respect to the individual

appellants and the fiscal years ended February 29, 1960, and February 28, 1961, in respect to the corporate appellant.

Following an audit of the appellant's income tax returns for the years involved, and on April 11, 1963, the Commissioner of Internal Revenue mailed notices of deficiencies to each of the appellants and subsequently assessed and collected additional taxes and interest asserted to be due (R. 5-7). Timely claims and amended claims for refund were filed by each of the individual appellants, and timely claims for refund were filed by the corporate appellant (R. 7-8). Under date of October 8, 1963, the appellants received statutory notices of disallowance in respect to their claims (R. 8). Within the time provided by Section 6532 of the Internal Revenue Code of 1954 and on November 14, 1963, appellants brought an action in the United States District Court for the District of Oregon for the recovery of the taxes paid (R. 27). Jurisdiction existed in the District Court under 28 U.S.C., Section 1346(a)(1). Judgment was entered May 17, 1965 (R. 20, 27). Within 60 days and on June 22, 1965, the appellants filed their Notice of Appeal (R. 21, 27). Jurisdiction is conferred upon this Court by 28 U.S.C., Section 1291.

QUESTIONS PRESENTED

1. Whether certain indebtedness incurred by Murphy Timber Co., a corporation, was its own obligation, as contended by appellants, or was actually the obligation of its individual shareholders, as contended by the appellee.

2. Whether certain logging equipment owned by Murphy Lumber Co., a partnership, was sold to Murphy Timber Co., as contended by appellants, or was transferred tax-free to the corporation in exchange for its stock under Section 351(a) of the Internal Revenue Code of 1954, as contended by appellee.

3. In the event the transaction involving the logging equipment is held to be a tax-free exchange, whether the cash proceeds received by the individual shareholders of Murphy Timber Co., in addition to the stock, constitute "other money or property" within the purview of Section 351(b) of the Internal Revenue Code of 1954.

STATUTES INVOLVED

The pertinent provisions of the Internal Revenue Code of 1954 are set forth in the Appendix, *infra*.

STATEMENT

For many years, Harry C. Murphy, Edward J. Murphy and Peter C. Murphy, three brothers, have been successfully engaged in various aspects of the lumber business (Tr. 4).[1] Prior to the taxable periods in controversy, they were equal owners of all of the outstanding stock of Murphy Logging Co., an Oregon corporation, which was operating under logging and road construction contracts with Crown Zellerbach Corporation near Grande Ronde, Oregon (Tr. 5-7). The operating assets

[1] "Tr." references are to the transcript of proceedings contained in Volume II of the record on appeal.

of the corporation were leased from Murphy Lumber Company, a partnership in which Harry C. Murphy held a 53 1/3 per cent interest, Edward J. Murphy held a 33 1/3 per cent interest, and Peter C. Murphy held a 13 1/3 per cent interest (R. 2).

In the fall of 1958, Murphy Logging Co. entered into an agreement with Santiam Lumber Company, a corporation owned by unrelated interests, to engage in contract logging for that company near Santiam, Oregon, an area over one hundred miles from Grande Ronde (Tr. 9). To conduct these operations, the corporation purchased the necessary logging equipment from Santiam (Tr. 9).

The Crown contracts were due to expire in the spring of 1959, but negotiations for renewal were successful (Tr. 8-9). At this point it was decided that it would be advantageous to keep the two logging operations separate (Tr. 9). Thereupon, Murphy Timber Co. was incorporated under the laws of the State of Oregon on February 2, 1959, with a stated capitalization of $1,500, represented by 15 shares of $100 par value stock which was issued equally to Harry C. Murphy, Edward J. Murphy and Peter C. Murphy (R. 2). This corporation then acquired the new contracts with Crown Zellerbach which had been negotiated by its shareholders (R. 3, Exs. B(1), B(2)).[2]

Prior to this time, Peter C. Murphy had been ex-

[2] Murphy Timber Co. was subsequently merged with Murphy Logging Co. under circumstances having no bearing on the instant case, but which accounts for the fact that Murphy Logging Co. is one of the appellants herein.

pressing dissatisfaction over the fact that he was receiving only 13 1/3 per cent of the profits resulting from the leasing of the logging equipment by the Murphy Lumber Company partnership, whereas Harry C. Murphy was receiving 53 1/3 per cent (Tr. 21). The brothers thus agreed in early 1959 to discontinue their practice of having a corporation conduct the logging and road construction operations in Grande Ronde using equipment leased from the partnership, and decided to sell the equipment to Murphy Timber Co. at a fair price to be determined by independent appraisal (Tr. 10-14). In this manner, each of the Murphys would thereafter share equally in the profits earned under the Crown contracts after the purchase price of the equipment had been paid.

Under date of March 1, 1959, Murphy Timber Co. entered into a contract to purchase certain logging equipment from the Murphy Lumber Company partnership for a price equal to its appraised value (R. 2-3, Ex. A). Later in the year an independent appraiser, A. E. Vanstrom, determined the total value of the equipment involved to be $238,150 (R. 3, Ex. C). On or about December 31, 1959, Murphy Timber Co. paid the agreed purchase price in cash to the Murphy Lumber Company partnership (R. 3).

Several times during the year 1959, Murphy Timber Co. borrowed funds from the First National Bank of Oregon upon executing promissory notes bearing interest at six per cent, payable quarterly (R. 4, Exs. I(1), I(2), I(3)). The notes were personally guaranteed by

each of the Murphy brothers (R. 4, Exs. Y(1), Y(2), Y(3)). The first series of loans totalled $75,000, with the proceeds used mainly for operating expenses (R. 17). The second series of loans totalled $240,000, with the proceeds used to purchase the equipment from Murphy Lumber Company (R. 17).

As a result of the continuing successful results obtained from the Crown contract, Murphy Timber Co. had substantial earnings from the outset from which it was able to repay the bank. The first series of loans was completely repaid by August 2, 1960 (Ex. H). Of the second series of loans, $75,000 had been repaid by the end of 1960 (Ex. H). Further repayments were deferred, however, upon the advice of counsel, because of the assertions being made by the Internal Revenue Service examiner which ultimately led to this case (Tr. 14-15).

The Murphy Lumber Company partnership reported the gain it realized on the sale of the logging equipment on its partnership return of income for the calendar year 1959, and each partner reported his distributive share of partnership gain on his joint individual income tax return for that year (R. 3). Following the purchase, Murphy Timber Co. used cost as its tax basis for the equipment acquired (Exs. U, V).

Upon audit of the individuals' and the corporation's income tax returns for the years involved, the examining Internal Revenue agent contended that the sale of the logging equipment should be treated as a nontaxable exchange and that the corporation's basis in the equipment

should be the same as it was when owned by the partnership (R. 4-5). He also contended that Murphy Timber Co. was "thinly capitalized" and that, therefore, the indebtedness to the bank incurred by Murphy Timber Co. should be treated as actually the obligation of the corporation's individual shareholders. Thus, in his view, when the corporation repaid the bank it was conferring constructive dividends upon the shareholders (R. 4-5). These contentions were upheld by the lower court (R. 13-19).

SPECIFICATION OF ERRORS

The District Court erred in holding and deciding:

1. That amounts borrowed by Murphy Timber Co., a corporation, from a bank were, in effect, borrowed by the individual shareholders of the corporation.

2. That the agreement of March 1, 1959, between Murphy Lumber Company, a partnership, and Murphy Timber Co., a corporation, effected a tax-free exchange of property for the stock of said corporation.

SUMMARY OF ARGUMENT

I

The District Court, in holding that Murphy Timber Co. was "thinly" capitalized, erroneously relied upon the imbalance between the company's stated paid-in capital and its indebtedness, and the fact that assets necessary to conduct its business were acquired with the loan proceeds. The Court failed to consider and correctly ap-

praise other elements of value which enhanced the equity of the company such as its going concern value, the background, experience, and ability of its management, and the fact that it received two valuable contracts to perform logging and road building services for no additional consideration.

Moreover, regardless of the capitalization of the company, the District Court erred in approving the unique realignment of the transactions with the bank suggested by the Internal Revenue Service. The parties intended the corporation to be the primary obligor on the notes, and the doctrine of substance over form was improperly used by the Court in holding that the individual shareholders were the real borrowers.

II

Section 351(a) of the Internal Revenue Code of 1954, which permits a tax-free transfer of property to a corporation solely in exchange for its stock, should not be applied where the parties intend a bona fide sale. The sale which took place in the instant case was bona fide. It enabled Peter Murphy to acquire twenty per cent of Harry Murphy's interest in the business under an arrangement whereby the purchase price could be paid for out of Peter Murphy's share of the earnings of the corporation's business.

III

In the event it is held that the tax-free exchange provisions of Section 351 are applicable, the cash consideration received by the individual shareholders should be treated as "other money or property" within the meaning of Section 351(b).

ARGUMENT

I

The Indebtedness Incurred by Murphy Timber Co. Upon Its Borrowings From the Bank Was in Fact Its Obligation and Was Not the Primary Obligation of Its Shareholders Who Guaranteed the Notes.

A. Introduction

Throughout this action it has been the government's theory that it may realign the loans made by the bank to Murphy Timber Co. as loans made directly to the company's individual shareholders. It claims that this unique action is proper because of its assertion that the company was inadequately or "thinly" capitalized. We know of no cases adopted or supporting such a position. The District Court, however, accepted the government's theory, concluding that the company was thinly capitalized, and described as a "masquerade" (R. 19) what we believe were normal commercial loan transactions with a large, established bank.

It is our position that Murphy Timber Co. was not undercapitalized for the purpose for which it was organized, and that the District Court failed to consider and correctly appraise all of the material elements bearing upon this question. We also contend that, regardless of the company's capitalization, the recasting of the transaction with the bank by the government and the District Court was contrary to law.

B. Murphy Timber Co. Was Not Undercapitalized.

The question of "thin capitalization" has been before this Court on numerous occasions and in various contexts. In a recent case it was held to present a mixed question of law and fact. *Taft* v. *Commissioner,* 314 F.2d 620 (9th Cir. 1963). Therefore, the conclusion reached by the District Court in respect to the capitalization of Murphy Timber Co. is subject to independent review on the essentially undisputed evidence adduced at trial, and without limitation by the "clearly erroneous" rule contained in Rule 52(a) of the Federal Rules of Civil Procedure (28 U.S.C., 1958 ed.).

Murphy Timber Co. was formed with a stated paid-in capital of $1,500. In determining that the company was undercapitalized, the District Court emphasized this fact and pointed out that it was necessary for the company to borrow $240,000 with which to acquire the equipment necessary to carry on its operations (R. 17). In reaching its conclusion, we submit that the District Court erred in considering only the stated capital of the company and in its implied assertion that the underlying operating assets of the company must be supported by equity capital.

This Court has repeatedly held that the actual value of the equity capital of a company is the important factor in these cases and not the amount of capital stated on its balance sheet. In *Estate of Miller* v. *Commissioner,* 239 F.2d 729 (9th Cir. 1956), a corporation was formed with an initial capital investment of $1,050. The three shareholders then advanced a total of $50,000 to the company for operating expenses. Subsequently, the

company purchased all of the assets of the shareholders' partnership for $86,622.49, issuing its note therefor. The Commissioner of Internal Revenue, noting the nominal stated capital of the company, asserted that the payments on the notes, which were made from the company's earnings, should be treated as dividends and not repayments of principal. The Tax Court agreed with the Commissioner;[3] but this Court reversed the decision upon determining that the real value of the equity investment was much greater than its stated value. This result was based upon an estate tax appraisal of the value of the stock shortly after formation of the corporation and the fact that the business had a favorable earnings history and potential.

In *Sheldon Tauber,* 24 T.C. 179 (1955), Acq. 1955-2 C.B. 9, a corporation was formed with a stated capital of $100. It then purchased the assets of the shareholders' partnership for $209,453.38, giving notes equal to the amount of the purchase price. In addition to the nominal stated paid-in capital, the corporation acquired from its shareholders certain "assets called good will" which were not reflected on its balance sheet.[4] Moreover, busi-

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[3] 24 T.C. 923 (1955). The reasoning contained in the Tax Court's opinion is remarkably similar to the reasoning of the District Court in the case at bar. For example, the Tax Court stated (p. 931): "The record before us satisfies us that the partners were in fact investing, and not selling their business for notes. Formal capital was nominal in amount, and grossly inadequate in view of the normal needs of the business operations anticipated. The partners had been in the same business for many years, and we are satisfied that they were well aware of this inadequacy."

[4] These assets consisted of the excess value of the assets purchased over their cost value as a going business, backlog of orders, and the background and experience of the personnel running the company. 24 T.C. at 181.

ness prospects were excellent at the time of transfer. The Commissioner made substantially the same argument he made in *Estate of Miller, supra,* but it was rejected by the Tax Court which, after considering the intangible assets acquired by the company, found that it was adequately capitalized.

This same reasoning was again applied by the Tax Court in *Ainslie Perrault,* 25 T.C. 439 (1955). In that case two brothers, who were partners, formed a corporation with a stated capital of $2,000. They then sold the partnership assets to the corporation for $973,000, taking back a note. In addition to these assets, the corporation received, for no additional consideration, orders or unbilled items of the partnership, good will having a substantial value, and rental contracts which immediately began producing sizeable earnings for the corporation. Again the Commissioner asserted that the corporation was inadequately capitalized, pointing to the nominal balance sheet capital account. The Tax Court, however, following *Tauber,* held that the real value of the equity capital of the corporation was substantially higher than its stated value, and declined to hold that the debt should be treated as equity.

We submit that the District Court failed to evaluate adequately the real equity contribution to Murphy Timber Co. The record discloses that the company received considerably more in value upon its incorporation than $1,500 in cash. It purchased an established operating logging business which had been highly profitable for a price equal to the appraised value of its individual tan-

gible assets. Thus, the corporation acquired, without additional consideration, the value inherent in the logging business as a going concern. This was a valuable intangible asset[5] which enhanced the value of the equity capital of the corporation. *Conestoga Transportation Co.*, 17 T.C. 506 (1951), Acq. 1952-1 C.B. 2.

The corporation also acquired the operational skills of the three Murphy brothers whose background, experience and ability in the lumber business has been unquestioned. While there was no formal management contract with the brothers which would enable this item to be considered a specific asset of the corporation, the fact remains that the company could certainly expect the Murphy brothers to continue its management. In valuing the business, this expectation would be a material factor. *United States* v. *Cornish,* 348 F.2d 175 (9th Cir. 1965). As Frank Morrow, the bank officer who approved the loans in question, put it (R. 26-28):

> Q. (By Mr. Duffy): Mr. Morrow, how long have you dealt with the loan account of Harry Murphy, Edward Murphy, Peter Murphy and the various Murphy organizations?
>
> A. Oh, actually dealing with them—we'll go back—I'm talking about handling their loans—eight years, going back to the time they came in the bank. I have known the Murphys; I have known what they have done; I have seen their files.

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[5] See, Wixon, Accountants' Handbook, Fourth Ed., p. 19:34 (Ronald Press). In effect, going concern value represents that portion of the value of a particular business as an integral operating entity which exceeds the total value of each of the business' individual assets valued separately. *United States* v. *Cornish,* 348 F.2d 175 (9th Cir. 1965).

Q. At the time that you were asked to make these loans to Murphy Timber Co. corporation, were you acquainted with their past business history in the logging business?

A. Definitely so.

* * * * *

THE COURT: Well, I think this one is pretty clear. If they had borrowed, you wouldn't have loaned the money to a $1,500 corporation where the amount of the loan equaled the amount of the used equipment, would you?

THE WITNESS: In their case, I wouldn't mind at all.

THE COURT: Even if they didn't sign personally?

THE WITNESS: Yes, even if they hadn't. As I recall, I don't think I even asked for a guarantee. I think it was offered to me.

In addition, the company also received two valuable contracts with Crown Zellerbach for no additional consideration. These contracts were essentially renewals of what in the past had been lucrative contracts held by Murphy Logging Co. The District Court refused to consider these contracts in the capitalization of the company, stating that there was no evidence offered of their value (R. 17). We submit that the record contains the best evidence available on this point, and that is the earnings and cash flow actually generated by them.[6]

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[6] It is to be noted that we are not concerned with fixing a value for the contracts on the date of incorporation wherein the relevant evidence would only include information available on that date. Here, we are merely attempting to show that the contracts received by the company had value. Thus, the performance obtained from them is highly relevant and is, in fact, the

The corporate income tax return for Murphy Timber Co. for its fiscal year ended February 28, 1960 (Ex. U), discloses that the company had a net income after taxes and depreciation of $20,978.69 for its first full year under the Crown contracts. Depreciation claimed on the return was $75,124.38. Thus, the company generated funds in the total amount of $96,103.07 during that year after payment of all costs and expenses. The company's cash receipts journal (Ex. AA) further shows the amount of gross proceeds received under the contracts for the year, which the company began to realize almost immediately after it commenced performing its logging and road building services. A breakdown is shown below:

CASH RECEIPTS FROM CROWN CONTRACTS

April, 1959	$ 578.58	Oct., 1959	$105,821.71
May, 1959	26,111.09	Nov., 1959	75,254.64
June, 1959	86,477.78	Dec., 1959	83,887.54
July, 1959	62,784.11	Jan., 1960	78,842.38
August, 1959	47,622.94	Feb., 1960	21,150.72
Sept., 1959	125,565.10	TOTAL	$714,096.59

These figures demonstrate that the Crown contracts had considerable value. Moreover, their worth in the lumber industry cannot be understated. It is well known that many of the individuals and firms involved in lumber are essentially concerned with the performance of services, whether it be logging, hauling, road construction, or a combination thereof. The securing of contracts to perform these services is, therefore, of utmost import-

most accurate evidence available. See *Ainslie Perrault, supra,* at 451, in respect to the results obtained by the corporation involved there on certain rental contracts it received.

ance to the success of their business. This is illustrated by the following testimony of Peter Murphy (Tr. 22-23):

> MR. DUFFY: * * * a corporation like this could operate without having to put any money down; that is, the $1,500 capitalization wouldn't mean anything, because even if they didn't have a dollar, they could go down to any equipment dealer, if they had a reputation, and start out on that basis.
>
> THE COURT: It would be kind of hard to get $200,000 of equipment from Western or logging contractors or any of the others, wouldn't it?
>
> THE WITNESS: No, it wouldn't, Judge, and it happens almost every day in our business, and that is why one of the competitive things about our business is that you can—the equipment companies are loaded with this type of used equipment, and they're happy *if you got a contract* in which to put it to work, to let you have that equipment on a lease basis or rental purchase or any other basis as long as you have the reputation that you can do the job. (emphasis supplied)

This economic fact in the industry has been important in tax litigation in cases involving the adequacy of a company's capitalization. In *Haley* v. *United States,* 60-1 U.S.T.C., para. 9169 (D.C. Ore. 1959),[7] a partnership had been engaged in contract logging for a large lumber company. Upon receiving advice from an attorney that a change in the form of business was necessary, the partners formed a corporation with a stated paid-in capital of $3,000. The partnership then sold its assets

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[7] Not officially reported.

to the corporation for approximately $50,000 with the two major partners becoming creditors of the corporation. The corporation also received, without additional consideration, the contract to perform logging services. In holding against the government's contention that the repayment of the loans constituted dividends, the District Court (Judge Kilkenny) determined that the corporation was adequately capitalized for the reason that the logging contract was a valuable asset of the corporation because it enabled the company to obtain outside credit without the shareholders giving their personal guarantee or subordinating their claims.

We submit that *Haley* supports our position in the case at bar despite the fact that the loans to Murphy Timber Co. were personally guaranteed by its shareholders. As noted before, Mr. Morrow, the bank officer, testified that he did not recall asking for the guarantees but thought they were voluntarily given (Tr. 27). He further stated that he was relying on the personal integrity and ability of the Murphy brothers in respect to the contracts which the company held, and not the guarantees (Tr. 29-31). Contrary to the District Court's conclusion (R. 19),[8] we believe that Mr. Morrow's testimony reflects the probable state of mind of most creditors who deal successfully with certain individuals and

[8] The District Court concluded that the "bank officer stretched the truth for a good customer on facts that did not and probably would never occur" (R. 19). What facts the Court had reference to we are not told. Moreover, although we recognize that the trial judge is entitled to accept or reject testimony in the exercise of his discretion, we submit that the record does not warrant the Court's statement to the effect that the bank officer "obviously . . . did not expect anyone to believe his testimony" (R. 19).

their business entities over a substantial period of time. No doubt a similar attitude prevailed between the debtor and the outside creditors in *Haley* since, obviously, an outside creditor would not loan a substantial sum to a corporation solely on the basis of a nominal capital account.

The value of a favorable logging contract was also emphasized by the Tax Court in the similar case of *J. I. Morgan, Inc.,* 30 T.C. 881 (1958), reversed and remanded as to another issue, *Commissioner* v. *J. I. Morgan,* 272 F.2d 936 (9th Cir. 1959). There, a corporation was formed with a stated capitalization of $10,000 to continue a contract logging business formerly conducted as a proprietorship. The corporation then contracted to purchase the operating assets of the business for $500,000 and assumed its liabilities in the amount of $129,682.55. Answering the government's assertion that the corporation was not adequately capitalized, the Tax Court stated (p. 892):

> Petitioner's ability to conduct its operations with small capital is accounted for at least in part by the fact that its principal asset, outside of its logging equipment, was a contract with Boise Payette Lumber Company to perform all of its logging operations.

The Commissioner of Internal Revenue announced his acquiescence to the decision in *Morgan* on the thin capitalization issue in 1959-1 C.B. 4.

The going concern value, the operational talents of management and the Crown contracts were not pur-

chased by either Murphy Timber Co. or its predecessor partnership. Therefore, quite properly, they were not reflected on the books and balance sheet of the company which includes only assets and liabilities at cost. Nevertheless, they were in fact contributed to the company by its shareholders as part of its equity capital. The fact that no specific value for these items was shown should be of no consequence. In *Ainslie Perrault, supra,* the Tax Court in a similar situation stated (p. 451):

> * * * We have not thought it necessary to determine the value of each separate asset that passed to the Corporation, but we have no hesitation in determining that they were of large value amounting to several hundred thousand dollars and constituted such an ample investment in the Corporation as to preclude any justification for holding under the thin capitalization doctrine that the transferred assets under the purchase agreement of January 5, 1948, should in substance be considered capital rather than a bona fide sale by the stockholders to the corporation. *John Kelly Co.* v. *Commissioner,* 326 U.S. 521; *Rowan* v. *United States,* 219 F.2d 51; *Sun Properties, Inc.* v. *United States,* 220 F.2d 171; *Sheldon Tauber,* 24 T.C. 179.

We submit that when the overall shareholder contribution to the capital account of Murphy Timber Co. is considered in the light of its true value, and bearing in mind the nature of the business involved, the company should not be deemed to have been undercapitalized.

In addition to erroneously relying upon the nominal stated capital of the company, the District Court also implied in its opinion that the necessary operating assets

of the company should be supported by equity capital (R. 17). This notion has been alluded to at times by the Tax Court. *Sam Schnitzer,* 13 T.C. 43 (1949), affirmed per curiam, *Schnitzer* v. *Commissioner,* 183 F.2d 70 (9th Cir. 1950) cert. denied, 340 U.S. 911 (1951); *Estate of Miller,* 24 T.C. 923 (1955), reversed, *Estate of Miller* v. *Commissioner,* 239 F.2d 729 (9th Cir. 1956). It has also been firmly rejected in more recent cases by the same court. *Sheldon Tauber, supra; J. I. Morgan, Inc., supra; Paul F. Murphy,* 21 T.C.M. 1161 (1962). Nearly all of the significant cases decided by this Court involving the incorporation of a going business have also rejected it.

In *Earle* v. *W. J. Jones & Son, Inc.,* 200 F.2d 846 (9th Cir. 1952), the taxpayer corporation and others formed a new corporation with a stated capital of approximately $1,000 for the purpose of exploiting a mine in Mexico. Loans of over $300,000 were made to the new corporation by its shareholders to finance the venture. When the business failed, the taxpayer claimed a bad debt deduction on its return for the advances made. The government contended that they should be treated as capital losses because they were in fact capital contributions. This Court held that the advances were true debt regardless of the fact that they were placed at the risk of the business, stating (p. 851):

> * * * To say that the advances were "gambled" and placed at the risk of the business does not help appellants. All unsecured loans involve more or less risk.

It is also clear from the facts in *Estate of Miller* v. *Commissioner, supra,* that in upholding the claimed in-

debtedness, this court attached little or no weight to the fact that necessary assets were being acquired from its shareholders by a newly formed corporation in exchange for debt obligations. There, an entire going business was acquired for debt by a corporation which was nominally capitalized.

Similarly, in *Taft* v. *United States, supra,* decided by this court in 1963, an electrical business previously operated as a sole proprietorship, was incorporated with a stated capital of $750. The corporation purchased all of the assets necessary for the conduct of the business from the individual proprietor giving its promissory note therefor. Despite the fact that essential assets were acquired from the person who was also the corporation's major shareholder, this Court held that the creditor position taken by the transferor was proper.

These decisions are clearly applicable here, and confirm the fact that it is quite normal for businesses to incur indebtedness in the acquisition of some or all of its basic assets.[9] We submit that when a debtor-creditor relationship is intended, even in respect to the purchase of assets essential to the business, that relationship should be respected for tax purposes. As this court stated in *Estate of Miller, supra,* at p. 734:

> * * * We know of no rule which permits the Commissioner to dictate what portion of a corporation's operations shall be provided for by equity financing rather than by debt. It is common knowl-

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[9] The trial judge himself recognized this point (at least during the trial) when he stated (Tr. 18): "Most businesses when they organize borrow money, don't they?"

edge that the choice of procedures in this regard will vary from corporation to corporation and we think that it cannot be said that any particular method of issuance of stock and incurrence of indebtedness can be labeled as "normal," and hence subject to approval by the Commissioner.

C. Regardless of the capitalization of Murphy Timber Co., the unique realignment of the loan transactions with the bank by the District Court was unwarranted.

This court has repeatedly held that a corporation may enter into a debtor and creditor relationship with its shareholders. *Taft* v. *Commissioner, supra; Estate of Miller* v. *Commissioner, supra; Earle* v. *W. J. Jones & Son, Inc., supra; Wilshire & Western Sandwiches, Inc.* v. *Commissioner,* 175 F.2d 718 (9th Cir. 1949); *Maloney* v. *Spencer,* 172 F.2d 638 (9th Cir. 1949); *Commissioner* v. *Proctor Shop, Inc.,* 82 F.2d 792 (9th Cir. 1936). As we observed in the preceding discussion, this has been true even though the corporation was nominally capitalized.

We recognize, however, that the government may step in and assert in a particular case that what the parties labeled as a loan or debt is in fact an investment of equity capital. *Sam Schnitzer, supra.* This is the well known "thin capitalization" doctrine.

Prior to the case at bar, however, the government has ordinarily used this argument only in situations where the shareholders have attempted to place themselves in the dual role of creditors of their corporation under circumstances which disclose that they really intended the alleged loans to be capital contributions. In these cases

the government has simply argued that the claimed instruments of indebtedness should be treated as the equivalent of stock. See *Kruse Grain & Milling* v. *Commissioner*, 279 F.2d 123 (9th Cir. 1960). Thus, it merely redetermines the character of the obligation.

Now, for the first time, the government is attempting to employ the thin capitalization doctrine to materially disturb the relationship of the parties involved in a common commercial banking transaction. The individual Murphy brothers, for sufficient reasons of their own, decided to consolidate their Grande Ronde logging operation into a single corporation. Since the corporation was to be the vehicle for conducting the business, quite understandably, the Murphys intended that the corporation itself was to be the primary obligor on its business loans. This was also the understanding of the bank representatives who approved the loans (Tr. 28-30). When the individual Murphy brothers, who had insulated themselves from the business entity by incorporating, affixed their names to the corporation's notes as guarantors, they naturally assumed that they were incurring only a guarantor's secondary liability.

We are sure the government will agree that there is a very real difference between being primarily obligated on a note and being only secondarily liable. Yet its argument in this case glosses over this material distinction on the alleged claim that the primary obligor was thinly capitalized. It thus misapplies a well developed doctrine to an entirely unrelated situation.[10] It is quite apparent

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[10] Perhaps the government is troubled by the fact that the

that by this device the government is attempting to squeeze dividends and the resulting tax thereon out of a situation where dividends were neither intended nor contemplated. In *Taft* v. *Commissioner, supra,* involving a similar attempt by the government, this Court stated (p. 623):

> In conclusion it is interesting to observe that in 1954 Taft had $106,931.82 in tax paid assets which he transferred to the corporation. In 1959, when he was repaid, he still had only $106,931.82. However, the Commissioner seeks a double taxation. He treats the payments as dividends, and insists that Taft should pay taxes thereon. Under our holding he need not.

We anticipate that the government will seek to find some support for its position in *Putnam* v. *Commissioner,* 352 U.S. 82 (1956). In that case the taxpayer was a shareholder of a publishing company and assisted in its financing by making advances to it and by guaranteeing its salaries and debts. The venture was eventually abandoned and the taxpayer was forced to pay on his guarantees. He claimed the payments on his return as an ordinary loss from a transaction entered into for profit under Section 23(e)(2) of the Internal Revenue

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guarantors are financially interested in the primary obligor on the notes. This apparently was the situation in *Ellisberg,* 9 T.C., 463 (1947), where a father guaranteed his son's note to the bank even though he knew there was no reasonable expectation of repayment. The Tax Court held that, in effect, the father borrowed the money from the bank directly and made a gift of the proceeds to his son. The father's claimed loss was, therefore, disallowed. This case is clearly distinguishable from the case at bar because here all parties involved expected the primary obligor to pay off its notes. Moreover, the case at bar involves business relationships between the parties and not the personal, family relationship involved in *Ellisberg.*

Code of 1939.[11] The government successfully contended, however, that the payments were only deductible as a short term capital loss on the ground that they should have been treated as nonbusiness bad debts within the meaning of Section 23(k) of the 1939 Code.[12] In upholding the government's contention, the Supreme Court simply stated that when the guarantor was forced to pay on his guarantee he became subrogated to the rights of the original creditor. With this premise announced, it then held that the loss sustained by the guarantor unable to recover from the debtor was by its very nature a loss from the worthlessness of a debt. Included in the Court's opinion is the following statement (pages 92-93):

> * * * There is no real or economic difference between the loss of an investment made in the form of a direct loan to a corporation and one made indirectly in the form of a guaranteed bank loan.

This analysis by the Supreme Court in a case involving an entirely different issue does not assist the government in the case at bar. There, the court was merely characterizing a taxpayer's loss which had been incurred. To him it made no "real or economic difference" whether it be considered a direct or indirect loan because in either event he lost his money. In the instant case, however, this is not true. Here the parties intended that the bank be repaid with corporate business profits since the money

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[11] Now Section 165(c)(2) of the Internal Revenue Code of 1954.

[12] Now Section 166(d) of the Internal Revenue Code of 1954.

was borrowed for use in acquiring and conducting the corporation's business.[13] Thus, it was important economically to the parties involved that the corporation was to be the real borrower and not the individual Murphy brothers who were not personally engaged in conducting the logging business and who would not personally have the business profits generated by the corporation with which to repay the loan.

It should be noted that the government's theory requires engaging in a three-way fiction, i.e., constructive shareholder borrowing, constructive capital contribution, and constructive payment for the shareholders' account. Apparently the District Court found this too much to accept alone, however, because in its opinion it felt compelled to also conclude that the substance of the banking transactions were contrary to their form (R. 19).

The doctrine of substance over form is well known in the tax law, having its genesis back in the early case of *Weiss* v. *Stearn,* 265 U.S. 242 (1924). It is not to be applied without restraint, however, as the opinion handed down in *Gregory* v. *Helvering,* 293 U.S. 465 (1935), cautions (p. 469):

> The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted * * *.

To this we should add the pertinent comment of the Court of Appeals for the Second Circuit in *Nassau Lens*

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[13] This is commonly known as "bootstrap" financing. See discussion at pages 30-31 *infra.*

Co., Inc. v. *Commissioner,* 308 F.2d 39 (2d Cir. 1962) at page 44:

> * * * In short, the courts have not attributed to Congress a general purpose underlying the entire Code to deprive the taxpayer in each case of freedom to choose between legal forms similar in broad economic sense but having disparate tax consequences.

In the case at bar the formal relationship between Murphy Timber Co., its shareholders, and the bank was consistent with the substance of the transactions into which the parties intended to and, in fact, did enter.[14] A legitimate form of business reorganization was consummated, and the financial arrangements employed were normal and consistent with the parties' purpose. This point is amply demonstrated by the manner in which the bank was repaid and by other conduct of the parties long before the Internal Revenue examiner came upon the scene.

II

The Transaction Whereby Murphy Timber Co. Acquired Certain Logging Equipment From the Murphy Lumber Company Partnership Was a Sale for Cash and Was Not an Exchange of the Equipment for Stock.

By contract dated March 1, 1959, Murphy Timber Co. acquired certain itemized logging equipment from

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[14] Whether the lower court misapplied the doctrine of substance over form is subject to full review by this court. See *Twin Oaks Co.* v. *Commissioner,* 183 F.2d 385 (9th Cir. 1950). It is a conclusion of law, or, at least, a mixed question of law and ultimate fact. *Weible* v. *United States,* 244 F.2d 158 (9th Cir. 1957).

the Murphy Lumber Company partnership for the total cash consideration of $238,150 (Ex. A). The price was determined by an independent appraisal of each of the assets involved (R. 3). The appraisal was of considerable importance in effecting the sale because of the conflicting interests of two of the individuals involved in the selling partnership and purchasing corporation (Tr. 10, 13, 22). The corporation borrowed the necessary funds for making the purchase from a bank with the loan bearing interest at the rate of six per cent.

Despite the fact that the parties clearly intended a sale, the examining internal revenue agent contended that the transaction should be viewed as a transfer of equipment to the corporation in a tax-free exchange for its stock within the purview of Section 351(a) of the Internal Revenue Code of 1954. Under this theory he rejected the corporation's use of cost as the basis for the assets acquired from the partnership, and contended that Section 362 of the Code applied to limit the corporation's basis for the assets to their basis when held by the partnership.

The question of the application of Section 351(a) to a transfer of property to a corporation where the parties intended a sale has arisen many times. *Taft* v. *Commissioner, supra, Estate of Miller* v. *Commissioner, supra, Haley* v. *United States, supra, Ainslee Perrault, supra, J. I. Morgan, supra,* and *Sheldon Tauber, supra.*[15] These

[15] See also, *Warren Brown,* 27 T.C. 27 (1956), Acq. 1957-2 C.B. 4, involving a logging company, and the recent case of *Charles E. Curry,* 43 T.C. No. 54 (1965), and cases cited therein.

cases were discussed above at length, and in each instance it was held that a bona fide sale took place. The government's argument that Section 351 should supplant the intended sale was rejected.

We recognize that the government has successfully applied Section 351(a) to certain transfers to closely held corporations. For example, in *Truck Terminals, Inc. v. Commissioner,* 314 F.2d 449 (9th Cir. 1963), several individuals owned stock in Fleetlines, Inc. and Truck Terminals, Inc., the latter a dormant corporation. The individuals involved decided to activate Truck Terminals as a subsidiary of Fleetlines so their stock in Truck Terminals was sold to Fleetlines for $5,000. Truck Terminals then purchased some heavy equipment from Fleetlines for $221,150, payable in installments. Subsequently, Fleetlines advanced $195,000 to Truck Terminals to enable Truck Terminals to pay off the balance due on the contract so that it could secure outside loans using the equipment as collateral. Still later, the $195,000 advance was cancelled by the issuance of additional stock to Fleetlines. The government successfully urged that Fleetlines had merely transferred the equipment to Truck Terminals in exchange for stock. Although couched in the form of a sale, it is clear that an exchange was all that really occurred because in the end all Fleetlines held was stock in Truck Terminals with Truck Term-

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In *Curry* the Tax Court stated: "The non-applicability of Section 351 appears to have been assumed in all the cases cited in the preceding paragraph. This rule appears so well settled that we would not feel justified in overturning it even if we were convinced it be erroneous. However, we are not so convinced."

inals possessing the equipment formerly owned by Fleetlines.[16]

Another theory prevailed for the government in *Pocatello Coca-Cola Bottling Co.* v. *United States,* 139 F. Supp. 912 (D.C. Ida. 1956). There, a corporation purchased assets to conduct its business from its shareholders for $244,000 in notes. The government asserted that the transaction was merely an exchange for stock on the ground that the character of the notes was such that they should be treated as stock or securities under Section 351(a). The notes provided that they were to be paid only out of the net earnings of the business and that they were to be subordinated to the claims of all general creditors of the corporation. Thus, quite understandably, it was held that the notes should be treated as preferred stock.

These cases do not support the government's contention that Section 351(a) should be applied in the case at bar. Here the sale was made for cash. It would be difficult indeed to attribute to cash any of the equity characteristics of stock. Thus, the government apparently chooses to ignore the cash consideration involved on the theory that it was really borrowed by the individuals. This is simply not what happened.

In addition to winding up the partnership as a leasing entity, the sale served to enable Peter Murphy to purchase twenty percent of Harry Murphy's interest in

[16] Essentially, the same approach, i.e., the single transaction doctrine, was applied in *Houck* v. *Hinds,* 215 F.2d 673 (10th Cir. 1954).

the business. The manner in which the transaction was carried out resulted in Harry Murphy immediately receiving cash for his twenty percent interest, and Peter Murphy being able to pay for it out of his share of the earnings of the business.

The purchase of an interest in a business to be paid for out of its earnings has been described as a "bootstrap" acquisition.[17] It is a common business technique and has been favorably recognized for tax purposes. *Commissioner* v. *Clay Brown,* 380 U.S. 563 (1965), affirming this Court, 325 F.2d 313 (9th Cir. 1964). *Jewell* v *United States,* 330 F.2d 761 (9th Cir. 1964). When Peter Murphy purchased a portion of Harry Murphy's interest in the business through the use of his share of the corporate earnings, this well-known practice was being employed. It was similarly used in *Sheldon Tauber, supra,* and *Charles E. Curry, supra,* to realign interests in a business, and received the approval of the Tax Court.

We gather that the chief reason for the government's distress over the sale is caused by the fact that Murphy Timber Co. claimed a basis for the assets acquired equal to their cost.[18] This result occurs, of course, in any situation where the parties intend a bona fide sale. Section

[17] In Lange, Bootstrap Financing: The Redemption Technique, 18 Tax L. Rev. 323 (1963), it is stated: "Bootstrap financing may be defined as the use of assets or credit of a purchased business to cover part or all of the purchase price."

[18] Unlike many cases in this area, the government could not be concerned with an attempt to bail out corporate earnings to the shareholders under the guise of interest because here the intrest was paid to the bank.

1012 of the Internal Revenue Code of 1954, Appendix, *infra*. We submit that as long as the sale transaction does not run afoul of any provision of the Internal Revenue laws it should be respected. The Tax Court appears to have accepted this point even under circumstances where the securing of tax benefits may have been the only reason for the sale. Its opinion in the *Curry* case, *supra*, contains the following statement:

> Respondent contends there was no "business purpose" for the sale of the corporation. It would seem that the mere desire to sell, even if the sole purpose was to realize capital gains, should be a sufficient business purpose (assuming always that the substance complies with the form). Sun Properties v. United States (220 F.2d 171, 5th Cir. 1955). Indeed it is difficult to imagine what added business purpose respondent would want for a sale of property.

The government has long been concerned with the tax benefits inherent in the sale of depreciable business property to a controlled corporate entity. In 1951 it obtained legislative relief when Congress added Section 117 (o) to the Internal Revenue Code of 1939.[19] This section does not attack the basis of the asset purchased but treats the gain realized by the seller as ordinary income rather than capital gain. It applies only to sales between an individual and a corporation in which the individual, his spouse, minor children, and minor grandchildren own more than 80 percent of the corporation's outstanding stock. Thus, clearly, it does not apply to the

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[19] Now Section 1239 of the Internal Revenue Code of 1954.

sale to Murphy Timber Co. However, the Treasury's proposed bill would have included the sale to Murphy Timber Co. The House of Representatives version of the bill would have applied the section to a sale by an individual to a corporation under certain circumstances solely because the individual's brothers also held stock in the corporation. H. Rep. No. 586, 82nd Cong., 1st Sess., 2 U.S.C. Cong. & Adm. News 1910 (1951). This proposal failed to pass the Senate. S. Rep. No. 781, 82nd Cong., 1st Sess., 2 U.S.C. Cong. & Adm. News 2041 (1951). A compromise was reached in Conference, however, which resulted in the passage of the section as it now reads. H. Conference Rep. No. 1213, 82nd Cong., 1st Sess., 2 U.S.C. Cong. & Adm. News 2135 (1951). It is significant that the attribution of stock between brothers was eliminated. Thus, the government in this case is requesting the Court for relief in an area after failing to receive it from Congress.

Subsequent to the taxable years involved herein, the Treasury again approached Congress for even broader relief in respect to sales of depreciable property regardless of the relationship between the seller and purchaser. Sections 1245 and 1250 were added to the Internal Revenue Code in 1962 and 1964, respectively.[20] These provisions require the seller of depreciable personal property and, under certain circumstances, a seller of depreciable real property to report certain portions of the gain realized upon the disposition of these assets as ordinary income rather than capital gain. These provisions, of

[20] Revenue Act of 1962, P.L. 87-834, § 13, 76 Stat. 1032. Revenue Act of 1964, P.L. 88-272, § 231, 78 Stat. 100.

course, are not applicable in the case at bar. However, they further demonstrate that the proper forum for adopting rules relating to the sale of depreciable assets is the legislature and not the courts.

III

In the event the transaction involving the logging equipment is held to be an exchange for stock, the additional cash received by the shaerholders of Murphy Timber Co. constituted "other money or property."

It is our contention that because the parties intended a sale, there was no tax-free exchange under Section 351 (a) of the Internal Revenue Code of 1954, Appendix, *infra*. However, if the Court determines that an exchange of property for stock occurred, then since cash was also paid to the individual shareholders by Murphy Timber Co., the "boot" provision of Section 351(b), Appendix, *infra,* is applicable.

Essentially, Section 351(b) provides that when "other money or property" is paid by a corporate transferee to a shareholder transferor in addition to the stock issued in a transaction falling under Section 351(a), then gain will be recognized to the shareholder transferor to the extent of the "other money or property" received. This results in a corresponding basis adjustment to the corporation under Section 362(a).

The lower court summarily rejected this argument without stating its reasons (R. 19). As best we can determine, it apparently did so by ignoring the cash and deciding that the equipment was transferred to the corporation solely in exchange for its stock. We submit that

the cash consideration paid by Murphy Timber Co. cannot be so easily dismissed. In substance as well as form it was paid by the corporation to the individual Murphys whether by sale or in conjunction with an exchange for stock. It is simply a misstatement of what really occurred to say that the individuals borrowed the money from the bank and nothing more.

CONCLUSION

It is clear that the Murphys intended a taxable event to occur upon the transfer of their partnership business to the corporation with a resulting change in the proportionate ownership of the business. They paid taxes accordingly on their individual returns for the year in which the transaction occurred (R. 3, Exs. E, F and G). The corporation, therefore, should not be denied its correct basis for the equipment acquired. The government's unique approach to find dividends where none were intended, and its attempt to limit the basis for the assets sold where no limitation should be made, should be rejected.

For these reasons, the judgment of the District Court should be reversed.

Respectfully submitted,

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CERTIFICATE

It is hereby certified that counsel for appellants have examined the provisions of Rules 18 and 19 of this Court and are of the opinion that this brief conforms to all requirements.

Charles P. Duffy
Joyle C. Dahl

October, 1965

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.):

SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR

(a) *General Rule.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

(b) *Receipt of Property.*—If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then—

(1) gain (if any) to such recipient shall be recognized, but not in excess of—

(A) the amount of money received, plus

(B) the fair market value of such other property received; and

(2) no loss to such recipient shall be recognized.

* * * * *

Sec. 362. BASIS TO CORPORATIONS

(a) *Property Acquired by Issuance of Stock or as*

Paid-in Surplus.—If property was acquired on or after June 22, 1954, by a corporation—

(1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferors) applies, or

(2) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

* * * * *

Sec. 1012. BASIS OF PROPERTY—COST

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments) * * *